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The Manufacturers Hanover
Economic Report

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Business Conditions Update

In the past few months, the word "recession" has cropped up with disturbing frequency in discussions regarding the business outlook. Because the last recession ended some 2-1/2 years ago, and because peacetime business upswings have lasted less than three years, on average, you can see why many people are nervous. It would appear that those who have been raising the specter of recession have good reason to do so. The recent spate of economic statistics has not painted a very bright picture. Indeed, negative numbers are becoming more common, thus more worrisome.

I don't wish to suggest that I am oblivious to bad news. However, a close scrutiny of all the economic statistics suggests that reports of this expansion's imminent demise—like those of Mark Twain's death—have been greatly exaggerated. There are quite a few pluses in the economic picture that are sustaining growth. Meanwhile, the conditions that normally precede the onset of a full-blown recession do not appear to be on the scene today. Accordingly, it is reasonable to expect that the gross national product adjusted for inflation, after rising faster in the second quarter than in the first according to the Government's "flash" estimate, may well advance at an even speedier clip during the third and fourth quarters of this year (see table inside).

Faster Growth Has Returned...

Let's look at the most recent calendar quarter first. You may recall that the February Economic Report suggested that it is necessary to take into account the influence of foreign trade in forecasting the gross national product nowadays because of the size of the trade deficit. The chief reason why the real GNP grew so slowly in the first quarter was a dramatic widening in the trade deficit compared with the fourth quarter. It was observed at that time that faster growth would be possible in the second quarter if the trade deficit did not worsen materially. This seems to have happened: The nine percent decline in the trade-weighted value of the dollar since February evidently was enough to keep the GNP version of the trade deficit, adjusted for inflation, from deteriorating much further.

On the positive side, let's examine two industries that are still exhibiting a fair amount of strength. Both domestic new-car sales and residential construction are still holding up. So far this year, Detroit is selling automobiles at an 8½ million unit annual rate. This is 15 percent above the average rate six months earlier—and almost two-thirds higher than the levels of three years ago. And even though the quotas on Japanese imports were recently lifted, Detroit's prognosis still looks good. For one thing, the Japanese are likely to move slowly and not flood the U.S. with their autos, figuring that if they do, these quotas might be reinstated. For another, Detroit seems to have found the right combination of style, size, and price to appeal to a growing number of buyers. The special interest rate financing packages that have been offered on a number of models seem to have helped, too.

...Thanks to More Consumer Spending...

For their part, housing starts are still strong—notwithstanding May's decline. New home construction has climbed by nearly 20 percent in the past six months. It's not hard to see why: Mortgage interest rates have tumbled 1½ points since 1983, bringing housing within the range of affordability of a growing percentage of U.S. families. Three years ago, when mortgage rates topped 18 percent, all but 15 percent of U.S. households were precluded from buying a home. The percentage who could afford to buy was the smallest in the postwar era and it showed up in the rate of new home construction, which at 855,000 in early 1982, was the lowest since the end of the second World War. Now that fixed mortgage

NO REPORTS IN SUMMER

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rates are down to 12 percent, some 40 percent of U.S. households can afford to buy a house. The last time this high a percentage could afford to buy a house, 1978, the rate of new home construction topped two million units.

Although there is a belief that the U.S. economy is shifting from manufacturing to services, the fact remains that so many industries benefit from the production of autos and housing that it would be difficult—if not impossible—for the U.S. economy to slide into recession while these two major industries are strong. And they are likely to remain healthy, since the consumer still seems to be in good shape. For one thing, there are almost a record number of people holding jobs. Total employment in May was nearly 107 million people. Meanwhile, nonfarm payrolls over the past year grew by 3½ million—not far below the 4½ million rise recorded in the previous 12 months.

This has occurred despite flatness in the manufacturing sector. Factory payrolls have changed little over the past year. By contrast, employment in service industries jumped by nearly three million over this time. More jobs, of course, mean more incomes, and with taxes and inflation down, buying power continues to expand. Along with a savings rate that seems to be back to normal, this should ensure continued gains in consumer spending in the months ahead. And while use of credit is up, so is wealth: People now own $2.21 of financial assets for each dollar of debt outstanding, ten percent more than the early 1980 low point.

...And A Decline in Interest Rates

Another factor that should be taken into consideration in assessing current business conditions as well as the outlook is the level of interest rates. Short-term interest rates are now at their lowest levels in at least seven years, while long rates are at five-year lows. And while this has reduced the growth in personal interest incomes somewhat, it has also lowered the cost of borrowing to buy houses, cars, or other big-ticket items for consumers—not to mention inventories, plants and equipment for business. Needless to say, the Federal Government is benefiting as well. Each percentage point increase in interest rates eventually costs Washington nearly $10 billion a year in interest on the national debt. The 3½-point drop in interest rates on Government securities since last summer has clearly saved Washington quite a lot of money in interest costs.

Credit the Federal Reserve for this favorable development. While the Fed tightened early in this expansion (May 1983) to avoid a resurgence of inflation, it loosened quickly (August 1984) to avoid a recession. I would expect the Federal Reserve to maintain this accommodative monetary posture until either GNP growth or inflation picks up substantially. I would not expect much additional ease on the part of the Fed since this might cause the money supply to grow so rapidly that it would reawaken inflation and the expectation of inflation. Furthermore, it might not be of much help in today's rather different economic circumstances.

As I have noted in the past (Economic Report—December 1984), the chief reason for our sluggish economic performance since last summer seems to be the rise in the value of the dollar in foreign exchange markets and its impact on the ability of U.S. companies to sell goods abroad and/or compete with imported merchandise. In this connection, lower interest rates might not only not depress the value of the dollar—they could even strengthen it, since the foreign exchange markets might conclude that lower interest rates would be a prelude to faster economic growth, hence better investment opportunities than exist abroad.

On the other hand, it would seem as though the Fed would not like to see a recession develop, either. For a number of key industries, regions, and nations have yet to recover from the last bout of recession and high interest rates. The strong dollar has caused increased competition, which has prevented many companies from raising selling prices—even in the face of rising costs—thus putting pressure on profits and margins. To close the gap between internally-generated funds and capital outlays, many companies were forced to tap external sources for funds, and because interest payments are tax deductible but dividends are not, most of these funds were borrowed, thus causing balance sheets to become highly leveraged. The country debt situation needs little elaboration. Many debtor nations depend on the United States to buy their exports, which they must sell in excess of what they import to earn enough money to service their debts. A recession here would clearly put the kibosh on developing country improvement.

Another reason for the Fed wanting to avoid a recession is that it would widen Washington's budget deficit. Since the Government's budget deficit is too big now, fiscal policy would appear to be unavailable to help fight a possible recession, leaving the entire burden on monetary policy. Those who remember their economic theory will recall the phrase "liquidity trap." John Maynard Keynes discussed this in analyzing the Depression of the 1930s, when no amount of monetary ease could seemingly get the economy moving. This led him to recommend the use of fiscal policy (deficit spending) as the Government's chief anti-slump tool. But if fiscal policy is inoperative, and monetary policy is not effective, then the next recession could turn out to be quite an experience.

June, 1985

MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	1984				YEAR 1984		< Actual		Projected > 1985		YEAR 1985	
	1	2	3	4	LEVEL	% CH	1	2*	3	4	LEVEL	% CH
Gross National Product	3553.3	3644.7	3694.6	[illegible]	3662.8	10.8	3810.6	3870.2	3932.8	4003.2	3904.2	6.6
GNP: $72	1610.9	1638.8	1645.2	1662.4	1639.3	6.8	1663.5	1676.2	1691.6	1707.1	1684.6	2.8
% Change, Annual Rates	10.1	7.1	1.6	4.3	6.8		0.3	3.1	3.7	3.7	2.8	
Consumption	2276.5	2332.7	2361.4	2396.5	2341.8	8.6	2446.5	2496.1	2539.1	2585.2	2516.7	7.5
Durables	310.9	320.7	317.2	326.3	318.8	13.9	334.8	344.1	359.6	369.4	352.0	10.4
Non-Durables	841.3	858.3	861.4	866.5	856.9	6.9	877.3	890.7	901.9	913.3	895.8	4.5
Services	1124.4	1153.7	1182.8	1203.8	1166.1	8.5	1234.4	1261.3	1277.7	1302.5	1269.0	8.8
Investment	623.8	627.0	662.8	637.8	637.9	35.2	646.8	656.6	671.3	687.3	665.5	4.3
Non-Residential	398.8	420.8	435.7	447.7	425.7	20.6	450.9	463.7	468.1	475.6	464.6	9.1
Producers Durable Equipment	256.7	270.7	284.2	289.7	275.3	23.4	288.0	294.8	297.8	304.6	296.3	7.6
Structures	142.2	150.0	151.4	157.9	150.4	16.0	162.9	168.8	170.2	171.0	168.2	12.3
Residential	151.2	155.6	155.3	153.5	153.9	16.4	155.2	160.8	170.1	177.3	165.9	7.8
Inventory Changes	73.8	50.6	71.8	36.6	58.2		40.7	32.1	33.2	34.4	35.1	
Net Exports	−51.5	−58.7	−90.6	−56.0	−64.2		−74.5	−83.6	−90.5	−95.1	−85.9	
Government Purchases	704.4	743.7	761.0	780.5	747.4	9.0	791.9	801.1	812.9	825.8	807.9	8.1
Federal Defense	213.4	220.8	220.3	231.6	221.5	10.5	233.9	240.7	245.2	250.5	242.6	9.5
Federal Civilian	54.2	75.5	81.7	84.1	73.9	6.7	85.9	85.8	86.6	85.6	86.0	16.3
State & Local	436.8	447.4	458.9	464.8	452.0	8.7	472.0	474.6	481.0	489.7	479.3	6.0
Final Sales: $72	1579.3	1618.5	1614.6	1645.6	1614.5	5.0	1644.4	1661.0	1676.7	1692.5	1668.7	3.4
% Change, Annual Rates	3.6	10.3	−1.0	7.9	5.0		−0.3	4.1	3.8	3.8	3.4	
Domestic Demand: $72	1619.2	1650.2	1672.2	1675.8	1654.4	8.7	1691.9	1704.5	1717.4	1730.2	1711.0	3.4
% Change, Annual Rates	12.9	7.9	5.4	0.9	6.7		3.9	3.0	3.1	3.0	3.4	
GNP Price Index (1972 = 100)	220.6	222.4	224.6	226.1	223.4	3.6	229.1	230.9	232.5	234.5	231.8	3.7
% Change, Annual Rates	4.4	3.3	4.0	2.8	3.8		5.4	3.2	2.8	3.5	3.7	
Consumer Price Index (1967 = 100)	306.9	309.7	312.5	315.3	311.1	4.3	317.8	321.2	324.3	327.7	322.7	3.7
% Change, Annual Rates	5.3	3.7	3.7	3.5	4.3		3.3	4.3	3.9	4.2	3.7	
Total Personal Income	2920.5	2984.5	3047.2	3096.2	3012.1	9.8	3141.1	3194.8	3242.2	3299.2	3219.3	6.9
Disposable Personal Income	2502.2	2554.3	2606.4	2644.5	2576.8	10.1	2653.4	2744.6	2762.6	2809.1	2742.4	6.4
Savings Rate	6.1	5.7	6.3	6.2	6.1		4.5	5.7	4.7	4.6	4.9	
Employment Rate	57.5	58.0	58.0	58.2	57.9		58.5	58.6	58.7	58.8	58.6	
Unemployment Rate	7.9	7.5	7.5	7.2	7.5		7.3	7.4	7.4	7.4	7.4	
Indus. Production (1967 = 100)	159.8	163.1	165.6	164.7	163.3	10.7	165.4	164.6	167.0	169.7	166.7	2.1
Housing Starts (000)	1947.0	1857.7	1663.0	1598.0	1766.4	3.8	1793.0	1858.3	1885.6	1944.3	1870.3	5.9
Domestic Auto Sales (000)	8103.0	8163.3	7897.7	7964.0	7957.0	17.1	8454.7	8308.3	8294.9	8310.5	8342.1	4.8
Corporate Pre-Tax Profits	243.3	246.0	224.8	228.7	235.7	16.0	222.3	208.4	215.2	223.0	217.2	−7.8
−Taxes	92.7	95.8	83.1	87.7	89.8		85.3	74.3	77.7	81.3	79.7	
Net Profits	150.6	150.2	141.7	141.0	145.9	14.5	137.0	134.1	137.5	141.7	137.6	−5.7
−Dividend Payments	77.7	79.9	81.3	83.1	80.5	10.5	84.5	85.0	86.9	89.1	86.4	7.3
Undistributed Profits	72.9	70.2	60.3	58.0	65.4	19.9	52.5	49.1	50.6	52.5	51.2	−21.8
+Depreciation	287.5	296.4	306.4	317.3	301.9		326.5	336.9	346.7	357.5	341.9	
−Inventory Profits	13.5	7.3	0.2	1.8	5.6		−0.9	5.0	10.0	15.6	7.4	
Net Cash Flow	346.9	359.3	366.5	373.7	361.6	17.5	379.9	381.1	387.4	394.4	385.7	6.7

The Absence of Pre-Recession Conditions...

Another reason for optimism regarding the balance of 1985 stems from the absence of conditions that usually appear just prior to a recession. These usually take the form of excesses of one type or another. For example, although employment is up, unemployment remains high. This suggests that for most industries there are potential workers who can be tapped to expand output, thereby minimizing the threat that shortages could slow down the economy. The same may be said for utilization of capacity. In contrast to this point in previous postwar expansions, the capacity utilization rate in the important manufacturing sector is barely above 80 percent. Two-and-a half years into the other recoveries that lasted this long found the utilization rate an average of four points higher, and the threat of shortages and bottlenecks that much greater.

Inventory policies are cautious. This means that business is unlikely to decide suddenly to cut back because of excessive amounts of unsold goods, as happened a year ago, when many sectors built inventories at a rapid pace. It seems that retailers were experiencing booming sales and expected this trend to continue. Those industries that serve the capital goods business, after examining surveys of business spending intentions which showed that a substantial rise in capital spending was in the offing, also built up stocks to prepare for this increase in demand. Elsewhere, there were those who believed

that inflation would worsen, thus making it worthwhile to build stockpiles before their prices rose substantially.

These expectations, by and large, were not fulfilled. After spending heavily in 1983 and early 1984, the consumer cut back by the middle of last year, leaving many retailers saturated with unsold merchandise. And while business capital spending, adjusted for inflation, did rise at the fastest clip in 20 years as the surveys suggested, the strength of the dollar caused a good part of this growth in demand to be channeled abroad. Thus many capital goods manufacturers were disappointed in their sales volume and they, too, had to cut back. And inflation not only did not flare up (Economic Report—March 1984), it slowed down, with price declines common in many wholesale markets in the last few months of 1984.

As a consequence, the U.S. economy underwent a mini-inventory correction. From an annual rate of $31 billion (real terms) in third-quarter 1984, stockbuilding slowed to about half that pace by second-quarter 1985, trimming more than one point from economic growth over this period. Had the rate of stockbuilding in second-quarter 1985 remained at third-quarter 1984's rate, the real gross national product would have grown by nearly three percent during these three quarters, instead of 1¾ percent.

Such an inventory correction is unlikely to impact the economic scene, near term. Retailers and capital goods industries, having learned their lessons, are extremely cautious and are watching inventories carefully. And few if any economists are expecting a significant flareup in inflation for the simple reason that the factors that have kept inflation down over the past year or two remain in place today. Indeed, it looks like 1985 will be the fourth year in a row in which consumer prices rise by four percent or less. You have to go back to 1967 to match this performance!

...Clears the Way for Continued Expansion

I hope this reasoning and analysis is reassuring insofar as the near-term outlook is concerned. Even though the important manufacturing sector has been flat on its back for more than a year now, the rest of the economy still seems to have enough vigor to keep the overall GNP on the rise, thus avoiding a recession. But this is no reason for policymakers to relax. Indeed, decisions made in Washington this year will have a significant impact on the outlook for business in 1986 and beyond.

In this connection, the timing of the President's tax reform program is most unfortunate. Notwithstanding the benefits it might confer on some individuals, industries and regions, it is likely to distract the Congress from dealing with the number one agenda item—reducing the budget deficit. Since cutting the deficit involves inflicting pain, whether by decreasing spending or increasing revenues, such a course of action is unlikely to be considered in 1986, when the entire House of Representatives and one-third of the Senate are up for election. If any politician had the notion that he or she could run for office successfully on such a belt-tightening program, the experience of 1984's Democratic candidate for President, who promised to raise taxes if elected and wound up carrying only his home state, should dissuade them, without a doubt. And if nothing is done in 1986 to reduce the budget deficit, it will be even harder to tackle the problem in 1987 when both parties will be posturing for the 1988 Presidential race.

Thus, no action this year promises literally four more years of mammoth budget deficits. If this occurs, the Government's annual interest cost, by its own calculations, will soon reach the size of this year's budget deficit. If and as that happens, all bets are off regarding recessions, double-digit inflation, or both. H

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Crowding Out

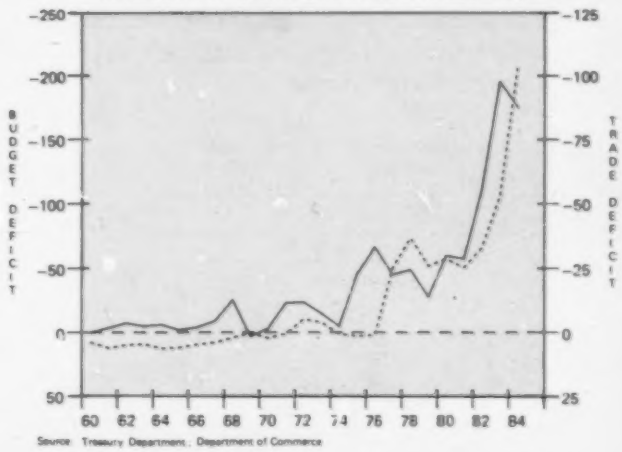
Superficially, it would appear as though the U.S. economy has dodged another bullet. After more than a year of sluggishness, several of the key indicators of business activity have begun to strengthen. Preliminary data for August indicate that the unemployment rate has broken out of its half-year range and has fallen to its lowest level since April, 1980, while employment reached a new record high. This obviously bodes well for personal incomes, providing consumers with increased buying power during the important back-to-school and fall shopping seasons. And if retail sales climb, output should not be far behind, since inventories have been sweated down in most lines of business, while the decline in the value of the dollar from its February peak suggests that domestic producers will share in some of this increased demand.

From a longer term perspective, comparisons appear even brighter. At the beginning of this decade, labor productivity was falling as the rate of inflation moved into the double-digit range. Likewise, most interest rates were in double-digit territory—some reaching record highs. Today, productivity is growing on the strength of renewed investment by business in plants and equipment, while inflation has slowed dramatically to less than four percent at the consumer level and below one percent at the producer or wholesale level. For their part, interest rates have fallen significantly, although not as much as inflation has receded.

Washington's Financing Needs...

Does this mean that we should sit back and anticipate another era of good economic times? Not necessarily. This is because we are left with a legacy of the economic policies that produced these seemingly favorable developments—a massive deficit in Washington's budget. Initially a stimulus to economic activity, the deficit has now become a drag, crowding out more and more of the private sector as the weeks and months go by. Yet because it is not impacting business in the conventional sense, some economists and a few politicians would have you believe that the budget deficit is not the ogre it obviously is.

CHART I
FEDERAL BUDGET DEFICIT (LINE) VS. MERCHANDISE TRADE DEFICIT (DOT) <BILLIONS OF DOLLARS>



Source: Treasury Department, Department of Commerce

To be sure, a cursory glance at the financial markets reveals little evidence of crowding out. As noted above, interest rates are down significantly from their recent peaks both in nominal and in real terms. In addition, money is plentiful for those who wish to borrow, since there are virtually no restrictions that prevent banks from gathering deposits and charging market rates of interest on loans. However, even here all is not entirely copesetic. For one thing, real interest rates (nominal interest rates minus the rate of inflation), while down from their peaks of several years ago, are still much higher than they were on average during most of the 1970s, not to mention the 1960s and the 1950s. This has inhibited those industries which are dependent on the availability of low-cost credit such as housing and automobiles, while making it difficult for many small and medium-sized businesses to stay alive. This year we will build at least 500,000 fewer housing units than we did more than a dozen years ago, when the age group that buys the most homes—the 25-34 year olds—was half the size it is today. And if Detroit produces eight million cars this year, it will still fall short of 1973's level by 1¾ million units.

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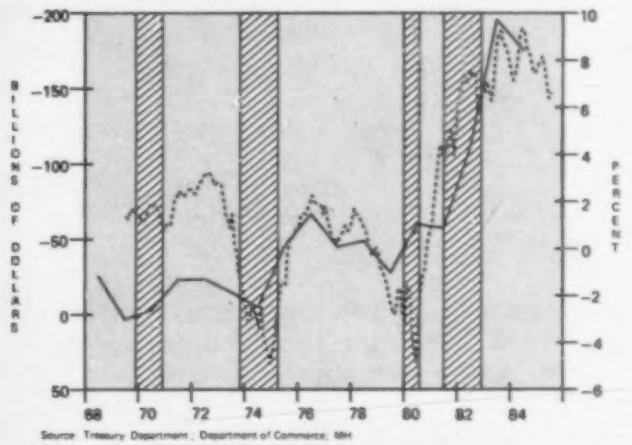
But the budget deficit is crowding more than just housing and autos. It is crowding virtually the entire goods-producing sector of the U.S. economy— not by pulling money away directly, but by creating conditions such that this sector doesn't need to borrow the funds. I speak of another legacy of the economic policies of the past few years—our trade deficit. Chart I shows that there is an unmistakable relationship between the budget deficit and the trade deficit. As the budget deficit moved out of its historical range to record levels, so did the U.S. deficit on merchandise trade. Imports speeded up while exports fell, depressing activity in the goods-producing sector of the economy. Those industries that export found markets for their products diminished overseas so they cut back production, while those industries which compete with goods produced from abroad also found they had to slash output, because more merchandise was entering the U.S. than before. In both cases, less production meant halted assembly lines, closed factories, lost jobs—and less need for funds.

CHART II
FEDERAL BUDGET DEFICIT (LINE) VS. REAL INTEREST RATE ON 7-YEAR TREASURY NOTES (DOT)



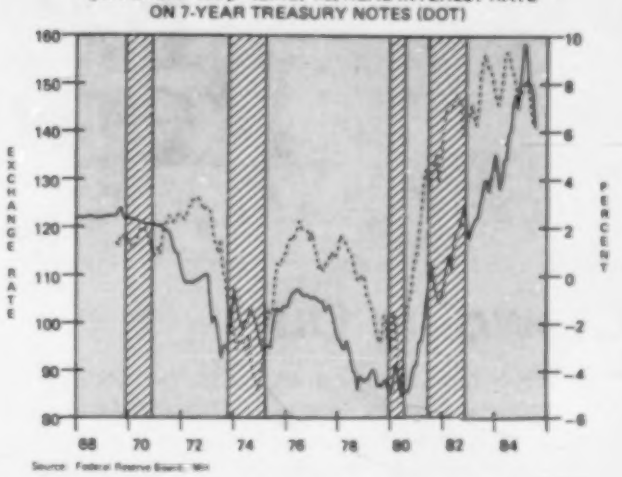
Source: Treasury Department, Department of Commerce, MH

It is not too difficult to determine the linkage between the budget deficit and the trade deficit. Chart II shows that the budget deficit caused real interest rates to rise out of their historical boundaries. These interest rates rose in response to the pressures on the financial markets that Washington's budget deficits represent. Since the financial markets are free of controls, and since Washington gets first crack at the availability of funds, interest rates are the means by which money is rationed. Washington is obviously not sensitive to the cost of borrowing money the way the private sector is; it borrows what it wants when it wants to with little regard for cost.

...Reach Overseas...

As high as these interest rates went, they would have been higher had the U.S. financial markets been closed to funds from abroad. As it is, these high interest rates attracted money from other countries, searching for a

CHART III
U.S. DOLLAR TRADE-WEIGHTED EXCHANGE RATE <MAR. 1973=100> (LINE) VS. REAL INTEREST RATE ON 7-YEAR TREASURY NOTES (DOT)



Source: Federal Reserve Board, MH

higher rate of return. In order to take advantage of these rates, holders of other currencies had to convert them into dollars. Thus, the dollar rose in value compared with the currencies of its major trading partners, a development that closely parallels the jump in real interest rates as can be seen in Chart III.

Of course, a change in the value of the dollar will affect our terms of trade. As the dollar climbed in value from its low in the middle of 1980, goods produced in the United States intended for sale abroad became more expensive to the holders of other currencies against which the dollar was rising. This prompted foreign consumers to either import fewer wares from the U.S. and/or shift their purchases to other countries where prices were more stable. Plainly, this led to a drop in exports from the U.S. At the same time, articles produced overseas became cheaper when sold in the U.S. because they were priced in currencies which were falling in value compared with the dollar. The end result, as Chart IV indicates, was a rise in the trade deficit in tandem with the rise in the value of the dollar.

A look at the financial side now will reveal more clearly the process by which Washington is crowding out the private sector. First, we should note that the U.S. borrows more than it saves. This is because the personal savings rate in the U.S. is relatively low while private and public demands for funds are comparatively large. While it may be true that the Federal Reserve has increased the supply of money and credit at a rather hefty pace over the past few years, it also true that the combination of borrowing by consumers, business, and Washington has expanded rapidly, too. As a consequence, the U.S. has been forced to borrow from foreign capital markets (see table).

As it turns out, these funds were available to be tapped by

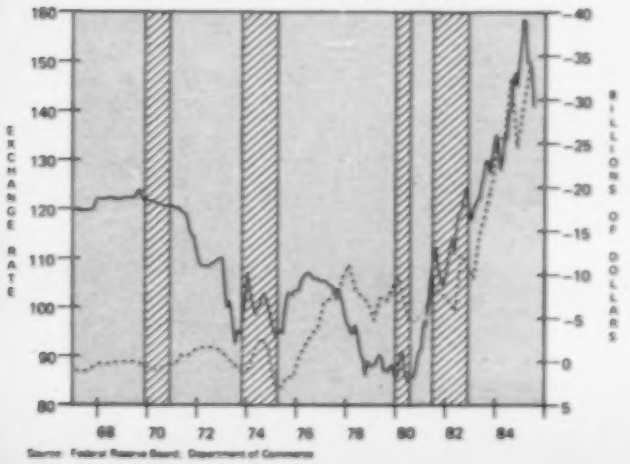
the U.S. because of two reasons: there were surplus funds and they were attracted to the U.S. by our high interest rates.

As far as the general public is concerned, these developments have been greeted with mixed reactions. Those whose jobs are secure and whose incomes have been growing have benefited from the strong dollar by being able to choose from a wider variety of products at relatively stable prices. On the other hand, those who work for companies less able to export and/or compete with imports have found their jobs less secure, thus are less sanguine about the current situation. Indeed, along with the managements of those companies and industries affected by our trade deficit, these workers are now pressuring their congressmen to do something to restrict the inflow of foreign-made goods and open up markets to U.S. exports.

...Causing A Massive Trade Deficit...

While there is a certain element of truth in the arguments made by many domestic companies regarding the subsidies that foreign governments give their exporters and the barriers they have erected to the entry of goods from the U.S. (and other countries), neither of these developments is especially new. What is new is the extent to which we are running this imbalance in our foreign trade and the harm it is doing to the U.S. economy. One can sympathize with the pleas for protection by those industries which have been affected by our trade deficit. However, attacking the symptom of our difficulties (the trade deficit), and not their cause (the Federal budget deficit), will probably create more problems than it solves. For one thing, any effort to cut the flow of imports by quotas or tariffs runs the risk of retaliation by others which will affect our exports. For another, there are some imports that are vital to our domestic activity such as components for

CHART IV
U.S. DOLLAR TRADE-WEIGHTED EXCHANGE RATE <MAR. 1973=100> (LINE) VS. MERCHANDISE TRADE DEFICIT, BOP BASIS (DOT)



Source: Federal Reserve Board, Department of Commerce

DOMESTIC INVESTMENT GAP
VS. FOREIGN CAPITAL INFLOWS
(billions of dollars; selected fiscal years)

Fiscal Year	Gross Savings[1]	Gross Investment[2]	Difference	U.S. Budget Deficit	Foreign Capital Inflows[3]
1980	$403	$403	$0	$60	-$2
1981	466	467	-1	57	-6
1982	445	441	4	111	8
1983	402	431	-29	195	41
1984	534	631	-79	175	102
1985*	555	646	-91	210	140

1) Gross savings equals the sum of gross private savings (corporate and household) and state and local government surpluses and capital grants received by the U.S.
2) Gross investment equals gross private domestic investment.
3) Current account balance, sign reversed (calendar years).
*Estimate
Source: Bureau of Economic Analysis; Treasury Department; MH

U.S.-made goods. There are others, such as videotape recorders, pocket calculators and Walkman-type portable radios that aren't even made in the U.S. which could also be affected.

But there is another, potentially more significant consequence that would arise from a sudden reduction in our trade deficit. If our trade deficit were to decline, other countries' trade surpluses would be similarly cut. In and of itself, this is fine—except that such action will reduce the funds that foreigners have available for investment in U.S. financial assets. Even this would be all right were it not for Washington's huge borrowing requirements associated with its budget deficit. Cutting off the inflow of foreign funds without reducing Washington's need for funds would lead to either sharply higher interest rates, if the Federal Reserve does not replace these funds by pumping up the money supply, a step-up in the rate of inflation if the Fed does—or both. What is more, the potential dollar scarcity that could result if protectionist legislation cuts the flow of imports could very well boost the dollar's value further, thereby squeezing our industrial sector even more.

...And Calls For Protection

Instead of pressuring Congress to enact protectionist legislation, businessmen and workers who have been adversely affected by our trade deficit should, instead, urge their elected representatives to agree with the President on a means of reducing our domestic budget deficit. One way or another, Washington's deficit will be financed; if not from funds that come from abroad, then from funds currently in the United States. If this latter situation develops and the Federal Reserve does not expand the money supply faster, then the indirect crowding out process that has been affecting mainly the goods-producing sector of the economy will become a direct crowding out phenomenon—depressing enough of the U.S. economy to plunge it into another recession.

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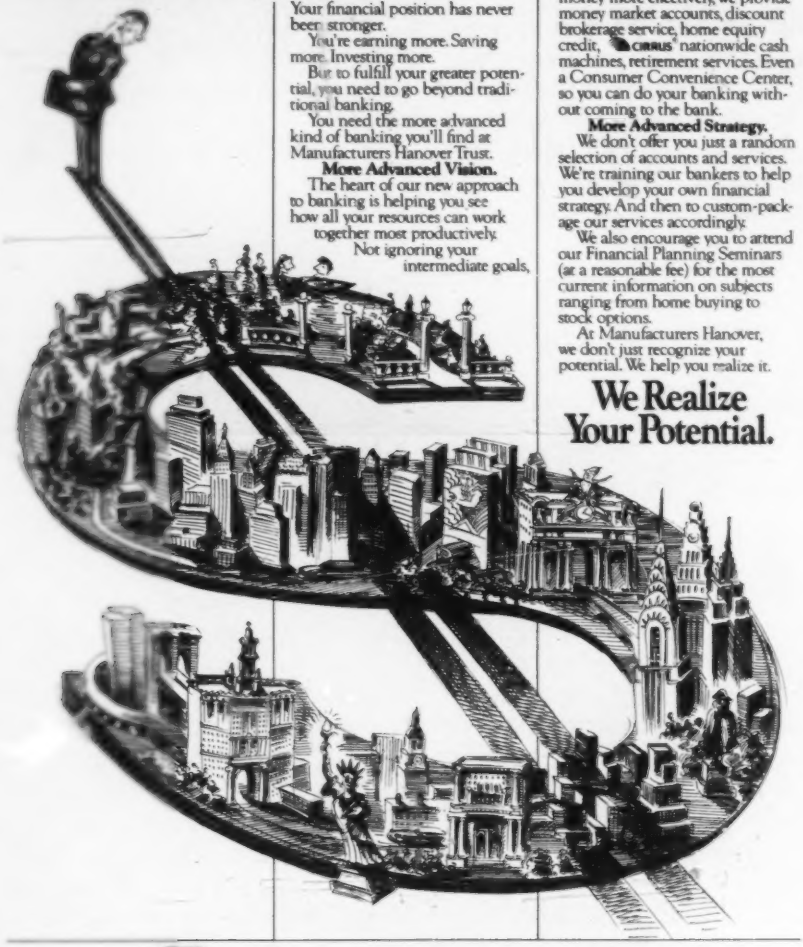

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

OCTOBER 1985

Economic Forecast For 1986

There is good news and bad news on the economic scene. The good news is that the near-term business outlook is much brighter than most economists and businessmen now anticipate. Not only is there no recession in sight, but the rate of economic growth is poised for a significant pickup—with virtually all sectors of the U.S. economy joining in before long. The bad news is that unless there is meaningful progress in reducing Washington's budget deficit, this rebound in economic activity will bring with it a revival of inflation. While this development in particular may not be unwelcome in some quarters (Economic Report—January 1985), it will ultimately lay the groundwork for an end to the current business expansion—albeit not for several years.

Call it a mini-recession, stagnation, or simply selected sluggishness, there is no doubt that the U.S. economy just had a close call. After expanding at an annual rate of about 6¼ percent during the first two years of this business expansion, the gross national product adjusted for inflation barely budged at all during first-half 1985. The real GNP at midyear was only half of one percent greater than it was at yearend 1984. Not surprisingly, the unemployment rate flattened during the first half of 1985, following a drop of nearly four percentage points during the previous two years. Notwithstanding the low rate of inflation and the Federal Reserve's willingness to accommodate the demands for funds in the economy by letting the money supply grow rapidly so that interest rates might decline, a number of economists and businessmen began to anticipate another recession.

A Change For The Better

However, over the summer a change seems to have taken place. Overall business activity as measured by the real GNP is reported to have grown by an annual rate of nearly 3½ percent during the third quarter. Coming in the context of a slight widening of the trade deficit and outright liquidation of business inventories—both of which represent a subtraction from the real GNP—this increase is more significant than it looks. As the table inside indicates, final sales (GNP less the change in business inventories) grew at a 5.9 percent clip in the third quarter after rising at a two percent annual rate in the first half of 1985.

Looking further into the third quarter's figures provides additional reasons for optimism. The consumer was a major factor contributing to the third quarter's pickup. This is not unusual, since personal consumption expenditures bulk so large in the GNP data, accounting for about two-thirds of the overall economy. The fact that a large part of the rise traced to a surge in auto sales has led some people to think that the consumer is going to cut back in the months ahead. There is a general impression that the consumer is tapped out. The savings rate is down to a 35-year low, while use of credit appears to be at a record high.

The Consumer Is Alive And Well

From here, it would appear that the consumer sector has quite a bit of life left in it. For one thing, the surge in sales of the 1985s has put a lot of new cars on the road and serves as a constant reminder to those who haven't bought a new car in recent years (the average age of cars on the road is 7½ years old—the oldest in at least 35 years) how new and different recent models can be. For another, several dramatically restyled offerings are scheduled to appear in the months ahead which should also give a lift to sales. And of course, one should not overlook the fact that interest rate incentives still exist.

To be sure, if the consumer is indeed tapped out, then he will not be able to buy new cars or other big-ticket items, no matter how attractive physically, technologically, or financially, they may be. Accordingly, it is necessary to look at the state of consumer finances to see just exactly what shape people are in. Besides the low savings rate

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noted above, those who have expressed concern about the state of the consumer refer to the apparent rise in household indebtedness. Last year consumer installment credit jumped by 20 percent, the highest annual increase since 1955. Compared with take-home pay, consumer installment credit now equals almost 19 percent—a record. What is more, people must now set aside 3½ percent of their after-tax incomes just to pay the interest on this debt compared with less than 2½ percent, on average, during the 1970s.

However, if one looks beneath the surface, one can be more sanguine. A recent study sponsored by the Federal Reserve Board and conducted by the Survey Research Center of the University of Michigan suggests that debt burdens are not as great as they seem. For one thing, it appears that almost half of the installment credit outstanding is owed by households in the highest income quintile. This proportion is a substantial increase from 1977, when the richest households held about 36 percent of such credit, and from 1970, when they accounted for only 22 percent.

Thus it is fairly evident that much of the recent rise in debt has been accumulated by those high income households which are probably best able to service it, if not take on more. The Fed study estimates that nearly three-quarters of the households in the highest income bracket, as well as the next highest, utilize installment debt. By contrast, less than one-third of the households in the lowest income bracket are in debt today; they account for less than five percent of total consumer credit outstanding.

Another factor influencing the growth of consumer credit has been the expanding use of credit cards. The way these figures are put together, use of credit cards adds to consumer debt, as might be expected. However, the Fed notes that credit cards are being used increasingly for convenience, rather than for borrowing. The Fed believes that approximately half of the card-using public pays credit card bills in full within the billing period, and that if such convenience use is netted out, the ratio of debt to income would be about one percentage point lower than it is.

Looking at autos in particular, it should be noted that maturities are lengthening. When the Fed calculates installment credit outstanding, it includes the principal amount plus all future interest payments on any loan that has a definite maturity date. While this definition has been consistent over time, the impact on measured debt outstanding can be quite misleading if the average maturity of the debt has increased—which it has, from three to over four years.

Another factor that must be taken into account when assessing the consumer's ability to handle debt is demographics. The movement of the baby boom generation into the age groups that tend to use debt most heavily has added to the growth of consumer credit. The 25-44 age group currently represents about 30 percent of the population but holds nearly 60 percent of the debt outstanding. These folks have always been disproportionate users of debt, since they are in the age brackets where consumption is the highest as families are formed, homes are purchased and furnished, etc. Thus, while their intensive use of debt is nothing new, the fact that this group is growing rapidly clearly adds to overall debt usage.

This factor is also aiding the housing market. New-home sales have exceeded 700,000 per month for the last three months. The last time this happened was in the summer of 1979. The percentage of households that can afford to buy a home has bounced up significantly from its 1982 lows and is now nearly 40 percent. This suggests that new-home construction, which has been soft of late, will perk up in the near future, adding thrust to overall economic activity.

Business Will Bounce Back

The gross national product figures reveal that business did not pull its weight in the third quarter. Nonresidential fixed investment decreased by $2½ billion in the third quarter, adjusted for inflation, after increasing nearly $7½ billion in the second. The decline was fairly widespread. Producers durable equipment purchases decreased by $1½ billion while spending on nonresidential structures fell by $1¼ billion. Considering the surge in capital spending in 1984, when such outlays rose by the fastest rate in 20 years, a slowdown in 1985 was to be expected. Add to this the sluggishness of the goods-producing sector of the U.S. economy caused by the overvalued dollar and you can see why business spending turned soft.

In addition, uncertainty over the tax reform issue has also affected business spending. Many corporate chieftains report that their firms are holding back on capital spending because they are concerned about what tax reform might do to the viability of such investments. As noted in the May 1985 Economic Report, doing away with the Accelerated Cost Recovery System and the investment tax credit will increase the cost of capital, decrease corporate liquidity, and thus will make capital investment less attractive. And this is not just one economist's opinion alone: It is the one issue on which economists of all stripes—Keynesians, monetarists and supply-siders—seem to agree.

But even here there are some bright spots. First of all, it is generally agreed in and out of Washington that tax reform is dead for 1985 and quite possibly for 1986 as well. The Administration does not appear to have lit a fire under the public at large or its major economic groups on this issue. People seem to think that, in view of Washington's budget deficits, the government simply doesn't have the money to give to them in the form of lower taxes without taking something away at the same time. Indeed, besides the issue of protectionism (Economic Report—September 1985), deficit reduction appears to be a higher priority item across the U.S.A. than tax reform. As it becomes apparent that tax reform is not in the cards, business will dust off some of its capital spending plans and put them into operation. Continued growth in consumer spending—especially as the lower-valued dollar channels more into domestically-produced goods—will also give businessmen a reason to re-examine their capital spending plans.

One aspect of business spending appears ready for change. The liquidation of business inventories over the summer has taken the ratio of inventories to sales down to 1.35. This means it would take 1.35 months to deplete inventories at the current selling pace—not a very long period of time, when you consider that the lowest this ratio has reached in the postwar era is 1.30. In other words—if spending continues to grow, business will run the risk of losing sales and market share unless it rebuilds

October, 1985
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual			Projected >								
	1985				YEAR 1985		1986				YEAR 1986	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3810.6	3853.1	3916.1	3993.1	3893.2	6.3	4067.6	4135.2	4219.2	4317.5	4184.9	7.5
GNP: $72	1663.5	1671.3	1684.8	1701.2	1680.2	2.5	1718.6	1732.5	1746.8	1764.6	1740.6	3.6
% Change, Annual Rates	0.3	1.9	3.3	3.9	2.5		4.1	3.3	3.3	4.1	3.6	
Consumption	2446.5	2493.0	2536.5	2582.2	2517.1	7.5	2641.0	2684.7	2737.7	2787.5	2712.7	7.8
Durables	334.8	339.2	355.6	362.6	348.8	9.2	374.1	379.7	384.4	388.5	381.7	9.7
Non-Durables	877.3	891.9	895.6	910.1	893.7	4.3	922.4	933.2	945.6	950.9	940.5	5.2
Services	1234.4	1261.9	1285.3	1319.5	1275.3	9.4	1344.5	1371.7	1407.8	1438.2	1390.6	9.0
Investment	646.8	643.2	622.8	641.4	638.6	0.1	660.3	673.1	683.4	707.2	681.0	6.6
Non-Residential	450.9	467.3	467.5	476.5	465.6	9.4	481.2	489.1	499.7	509.4	494.9	6.3
Producers Durable Equipment	288.0	299.0	300.6	307.5	298.8	8.5	311.2	317.9	327.5	335.8	323.1	8.1
Structures	162.9	168.3	166.8	169.1	166.8	10.9	170.0	171.2	172.2	173.7	171.8	3.0
Residential	155.2	158.0	163.4	162.6	159.8	3.8	166.8	169.7	171.4	172.5	170.1	6.5
Inventory Changes	40.7	17.9	−8.1	2.3	13.2		12.3	14.2	12.2	25.2	16.0	
Net Exports	−74.5	−94.0	−89.2	−90.9	−87.2		−85.5	−85.2	−78.5	−69.5	−79.7	
Government Purchases	791.9	810.9	845.9	850.4	824.8	10.4	851.7	862.7	876.6	892.3	870.8	5.6
Federal Defense	233.9	241.1	253.1	250.9	244.8	10.5	255.3	259.3	265.8	270.6	262.8	7.4
Federal Civilian	85.9	83.2	93.9	92.1	88.8	20.1	80.1	77.8	75.8	76.4	77.5	−12.7
State & Local	472.0	486.7	498.9	507.3	491.2	8.7	516.3	525.6	535.0	545.3	530.5	8.0
Final Sales: $72	1644.4	1663.6	1686.9	1700.1	1673.6	3.7	1713.3	1726.6	1741.7	1754.7	1734.1	3.6
% Change, Annual Rates	−0.3	4.6	5.9	3.2	3.7		3.2	3.1	3.6	3.0	3.6	
Domestic Demand: $72	1691.9	1705.1	1718.8	1733.8	1712.4	3.5	1746.0	1755.5	1763.9	1776.3	1760.4	2.8
% Change, Annual Rates	3.9	3.2	3.3	3.5	3.5		2.8	2.2	1.9	2.9	2.8	
GNP Price Index (1972 = 100)	229.1	230.5	232.4	234.7	231.7	3.7	236.7	238.7	241.5	244.7	240.4	3.8
% Change, Annual Rates	5.4	2.6	3.3	4.0	3.7		3.4	3.4	4.9	5.3	3.8	
Consumer Price Index (1967 = 100)	317.8	321.1	323.0	325.8	321.9	3.5	328.9	332.3	336.5	340.8	334.6	3.9
% Change, Annual Rates	3.3	4.2	2.4	3.5	3.5		3.9	4.2	5.1	5.2	3.9	
Total Personal Income	3143.8	3174.7	3199.1	3266.1	3195.9	6.1	3322.8	3387.6	3473.8	3546.1	3432.6	7.4
Disposable Personal Income	2654.8	2726.5	2712.6	2768.4	2715.6	5.4	2817.0	2868.3	2936.5	2993.9	2903.9	6.9
Savings Rate	4.5	5.1	2.9	2.7	3.8		2.5	2.6	3.0	3.1	2.8	
Employment Rate	58.5	58.3	58.4	58.6	58.4		58.7	58.8	59.0	59.2	58.9	
Unemployment Rate	7.3	7.3	7.1	7.1	7.2		7.0	6.9	6.9	6.8	6.9	
Indus. Production (1977 = 100)	123.8	124.2	124.5	127.4	125.0	2.8	128.7	129.5	129.9	130.8	129.7	3.8
Housing Starts (000)	1795.0	1771.7	1864.0	1786.8	1754.4	−0.7	1782.6	1769.9	1776.1	1782.0	1777.7	1.3
Domestic Auto Sales (000)	8454.7	8238.3	9440.7	8132.4	8566.5	7.7	8015.1	8027.3	7546.5	7758.4	7836.8	−8.5
Corporate Pre-Tax Profits	222.3	221.0	211.0	223.7	219.5	−6.9	239.3	246.2	250.4	270.2	251.5	14.6
− Taxes	85.3	83.6	75.3	81.6	81.4		91.5	94.2	95.7	106.7	97.1	
Net Profits	137.0	137.4	135.7	142.2	138.1	−5.4	147.7	152.0	154.7	163.4	154.5	11.9
− Dividend Payments	84.5	85.6	86.4	87.5	86.0	6.8	89.3	91.4	93.8	96.0	92.6	7.7
Undistributed Profits	52.5	51.8	49.3	56.9	52.6	−19.5	58.9	60.9	66.4	70.6	64.2	21.9
+ Depreciation	326.5	336.6	349.0	361.4	343.4		365.8	370.2	374.0	377.5	371.9	
− Inventory Profits	−0.9	−2.5	−6.0	10.7	0.3		14.9	15.8	22.1	24.8	19.4	
Net Cash Flow	379.9	390.9	404.3	407.5	395.7	9.4	409.8	415.2	418.2	423.3	416.6	5.3

inventories. And since the only thing worse than losing sales for lack of business is losing sales for lack of merchandise, it is not unreasonable to expect business to increase its outlays on inventories in the near future.

Another reason to expect a pickup in economic growth stems from the drop in the value of the dollar on foreign exchange markets. Between the end of February and the end of September the dollar declined by 15 percent against a market basket of major currencies. This was enough to stem the rise in our deficit in foreign trade. In July and August the red-ink total narrowed by more than 20 percent compared with the immediately preceding two months.

The announcement by the finance ministers of the five leading industrial countries (G-5) that they were dissatisfied with the value of the dollar in foreign exchange markets and that they would intervene from time to time to force it lower resulted in a further decline of around five percent. Even if the dollar moves no lower, the trade deficit will shrink further as imports slowly become more expensive and exports become cheaper overseas. This will give a lift to domestic business, but it will still leave us with a sizable trade deficit, thus vulnerable to protectionist pressures. It is safe to say that the central bankers will make further attempts to get the dollar lower if it shows no tendency to go lower by itself. The lower the dollar, the more of a lift to our domestic economy, since more and more of domestic spending will be channelled into domestically produced goods.

Have We Seen Inflation's Lows?

Now for the bad news. We may have seen the low point in the inflation rate. Aside from the recessions we went through in 1980 and again in 1981-82, the key reason why inflation has been held down this long into the business upswing has been the overvalued dollar. Calculations by this Bank suggest that each ten percent that the trade-weighted value of the dollar increased between July 1980 and February 1985 reduced our annual rate of inflation by one percentage point. The 20 percent drop in the value of the dollar over the past eight months alone is good for at least one percentage point more inflation next year, if not two. And should the dollar move even lower, the rate of inflation will pick up even more.

On the monetary side, there is certainly plenty of liquidity around that could fuel a higher rate of inflation. The narrowly-defined money supply (M1) will probably rise this year by the fastest rate for any year in postwar history. The broader aggregates, M2 and M3, are rising more slowly than M1, but their growth rate is also high compared with their own historical trends. It is hard to see how the Fed can avoid even faster rates of monetary growth, now that the dollar has come down. This is because the demand for funds from both the private and public sectors remains strong, while the lower-valued dollar, by definition, means that there are less foreign funds coming into the U.S. for investment in financial assets.

To be sure, the rate of inflation will not pick up right away. The table suggests that the consumer price index will go up at its recent rates for at least a couple of more quarters. However by this time next year, the CPI is likely to be rising at rates of five percent or better. Looking even further ahead, other factors such as a tightening of the labor markets, a higher rate of capacity utilization, the reappearance of inflation psychology combined with continued economic growth—not to mention additional fiscal and monetary stimulus—should force the inflation rate even higher in 1987. Double-digit inflation is not in the cards for 1986, but I would not rule out that possibility for 1987 or later.

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